In the Supreme Court of the United States

OCTOBER TERM, 1974

No. 74–124

BLUE CHIP STAMPS, ET AL., PETITIONERS

v.

MANOR DRUG STORES, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE

QUESTION PRESENTED

The Commission will discuss the first question presented in the petition: Whether a party who neither purchased nor sold securities has standing to seek damages for injuries caused it by a violation of the antifraud provisions of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b–5 thereunder.

INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

The Commission is primarily responsible for the administration and enforcement of the federal securities laws, including the Securities Exchange Act of 1934. Private actions by the victims of securities

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frauds, however, are a "necessary supplement" to the Commission's enforcement activities. *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 382; *J. I. Case Co.* v. *Borak*, 377 U.S. 426, 432. The Commission is concerned that the courts do not adopt restrictive constructions of the securities laws and of the Commission's rules that would weaken the protections they afford investors.

To further this objective the Commission as *amicus curiae* in private actions has argued consistently that the right to recover damages for violations of the broad antifraud provisions of Rule 10b–5, authorized by Section 10(b) of the Securities Exchange Act, should not be limited to actual purchasers and sellers of securities but should extend to all investors and potential investors. The Commission believes that this case presents the question in clear form and is therefore an appropriate occasion for this Court to resolve this important issue in the administration of the securities laws.

STATEMENT

In December 1963 the United States filed a civil antitrust action against Blue Chip Stamp Co. and nine of its twelve stockholders.[1] The complaint charged that the defendants had conspired to restrain and had monopolized the trading stamp business in California. In addition to Blue Chip, the defendants were major

[1] This statement of facts is taken from the opinion of the court of appeals and from the complaint filed by Manor Drug Stores. Because the district court granted petitioners' motion to dismiss the complaint, its factual allegations must be accepted as correct. *Conley* v. *Gibson*, 355 U.S. 41.

California retailers who used Blue Chip stamps and who collectively owned 90 percent of Blue Chip stock. The suit was settled in 1967 by a consent judgment. See *United States* v. *Blue Chip Stamp Co.*, 272 F. Supp. 432 (C.D. Calif.).

The judgment provided that Blue Chip Stamp Co. would be merged into a new corporation, Blue Chip Stamps. Securities of the new corporation were to be offered, at "bargain" prices, to retail firms—including Manor Drug Stores, the plaintiff in this action—that had used Blue Chip stamps but had not owned stock in Blue Chip Stamp Co. Each of these retail firms was entitled to purchase securities in proportion to the amount of stamps it had used. The complaint of respondent Manor Drug Stores alleges that the securities were offered at a bargain in order to allow the users to share in the undistributed profits of Blue Chip Stamp Co.

The complaint asserts that the defendants (now petitioners) devised a scheme to dissuade the offerees, by means of misleading statements, from purchasing the securities. The apparent motivation for the scheme was that any securities not purchased in the "bargain" offer could be sold later on the open market by petitioners at a greater price, thereby increasing the assets of Blue Chip Stamps and the value of each share owned by the other petitioners. In order to discourage the offerees from purchasing the securities petitioners in the prospectus unduly emphasized certain "Items of Special Interest" that might adversely affect the value of the securities; the prospectus also contained inflated estimates of anticipated expenses. Because of these misleading representations certain offerees did

not purchase the securities. Although the offering price of the new securities was $101, the market value was alleged to be $315 at that time (Pet. App. A–4, E–12).

The district court dismissed the complaint on the basis of the so-called "*Birnbaum* rule," announced in *Birnbaum* v. *Newport Steel Corp.*, 193 F. 2d 461 (C.A. 2), certiorari denied, 343 U.S. 956, which held that a person who is neither a purchaser nor a seller of securities has no cause of action under Section 10(b) of the Securities Exchange Act of 1934 or Rule 10b–5 thereunder.

Respondents appealed, but before the appeal was decided another panel of the Ninth Circuit, in *Mount Clemens Industries, Inc.* v. *Bell*, 464 F. 2d 339, adopted the *Birnbaum* rule. A divided panel in the instant case accepted *Birnbaum* and *Mount Clemens* as controlling, but reversed on the ground that those cases did not involve a situation where the plaintiffs had a right to buy securities "at a fixed price and in a fixed amount" (Pet. App. A–10). The court held that the offering of securities in this case, in compliance with the antitrust decree, "served the same function as" a contract for the purchase or sale of securities and therefore supported a damages remedy for the nonbuying plaintiffs. A suggestion for rehearing *en banc* was rejected, five judges dissenting.

REASONS FOR GRANTING THE WRIT

The Commission agrees with the court of appeals that respondents, although neither purchasers nor sellers of securities, have standing to assert a claim

for damages under Section 10(b) of the Securities Exchange Act of 1934. The Commission believes, however, that the proper ground for this conclusion was not the court's distinction of *Birnbaum*, but that the *Birnbaum* rule itself is unsound and should be rejected.

The Commission urges this Court to review this case because the validity of the *Birnbaum* rule is a recurrent question that has confronted the courts of appeals for more than 20 years. The question was left open in *Securities and Exchange Commission* v. *National Securities, Inc.*, 393 U.S. 453, 467, n. 9; and *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 13–14, n. 10; the courts of appeals are divided and inconsistent in their treatment of the problem. The *Birnbaum* rule reflects an approach at odds with the remedial manner in which the securities laws should be interpreted, and it denies redress to an entire class of investors who are victims of securities frauds.

1. Within the last decade and a half the antifraud provisions of the federal securities laws, and particularly Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b–5 thereunder, have become major tools used to effect Congress' decision "to prevent frauds in the sale * * * [of] securities sold in interstate and foreign commerce and through the mails," Preamble, Securities Act of 1933 (48 Stat. 74), and "to prevent inequitable and unfair practices" in connection with such securities transactions, Preamble, Securities Exchange Act of 1934 (48 Stat. 881). This Court has rejected various restrictive constructions

and limitations of the antifraud provisions that might frustrate the congressional desire to eliminate deceptive practices. See *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 151; *Superintendent of Insurance* v. *Bankers Life & Casualty Co., supra*; *Mills v. Electric Auto-Lite Co., supra*, 396 U.S. at 382; *Securities and Exchange Commission* v. *Capital Gains Research Bureau*, 375 U.S. 180, 195.

The *Birnbaum* rule is yet another such restrictive construction unjustified by the words or the purposes of the Act. Although there is a private right of action for damages caused by a violation of Rule 10b–5, *Affiliated Ute Citizens, supra; Bankers Life & Casualty Co., supra*, the *Birnbaum* rule operates to deny this remedy to an entire class of fraud victims, depriving them of the protection the securities laws were intended to afford. There are often misrepresentations the purpose or effect of which—as in the instant case—is to prevent the purchase or sale of securities. There is no reason why victims of a fraud who suffer a loss should be treated less favorably when the loss results from their failure to make a "bargain" purchase than when it results from making a purchase that turns out to be no bargain.

2. Nothing in the Act or in Rule 10b–5 justifies the *Birnbaum* rule. Both the Act and Rule prohibit fraud "in connection with the purchase or sale" of a security. By this language the Congress and Commission sought to prevent all deceptive acts or practices which could affect investment decisions; a fraud committed to induce an investor to refrain from purchasing securities affects investment decisions no less than one

committed as part of a completed purchase or sale. In both instances the purchaser—prospective in one case and actual in the other—has been victimized by fraud in a securities transaction, and that is the evil which Congress attempted to prevent in Section 10(b).

Indeed, this Court has rejected the basic premise of *Birnbaum*. *Birnbaum* held that Section 10(b) and Rule 10b–5 "extended protection only to the defrauded purchaser or seller" of securities, 193 F. 2d at 464, and, consequently, that a person who could not claim to be within either category did not state a claim upon which relief could be granted. In *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, *supra*, 404 U.S. at 12–13, however, this Court pointed out that Rule 10b–5 prohibits all "deceptive practices touching * * *" the purchase or sale of securities by investors, and rejected the assumption made in *Birnbaum* that Section 10(b) "was directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities rather than at fraudulent mismanagement of corporate affairs." 193 F. 2d at 464.

Birnbaum has also been undermined by those more recent decisions affording standing to nonbuyers for purposes of seeking an injunction. *Britt* v. *Cyril Bath Co.*, 417 F. 2d 433 (C.A. 6); *Mutual Shares Corp.* v. *Genesco, Inc.*, 384 F. 2d 540 (C.A. 2).[2] To the extent *Birnbaum* is a rule of "standing," its denial of standing is based on a narrow reading of the "pur-

[2] Cf. *Mount Clemens*, *supra*, 464 F. 2d at 341–342; *Landy* v. *Federal Deposit Insurance Corp.*, 486 F. 2d 139, 156 (C.A. 3), certiorari denied, 416 U.S. 960.

chase or sale" language of the Act and Rule. If this language does not prevent nonbuyers from seeking injunctions, it should not prevent nonbuyers from seeking damages.

3. There is a conflict among the circuits. One circuit has disapproved the *Birnbaum* rule; other circuits have adopted it, albeit with slightly different statements of its scope. The Court of Appeals for the Seventh Circuit has flatly rejected *Birnbaum*. *Eason* v. *General Motors Acceptance Corp.*, 490 F. 2d 654, 661, certiorari denied, 416 U.S. 960. The Courts of Appeals for the Second,[3] Third,[4] Fifth,[5] Sixth,[6] Eighth,[7] and Ninth[8] Circuits accept *Birnbaum*. The Courts of Appeals for the First,[9] Fourth, Tenth,[10] and District of Columbia Circuits have not faced the problem.

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[3] See, *e.g.*, *Iroquois Industries, Inc.* v. *Syracuse China Corp.*, 417 F. 2d 963, certiorari denied, 399 U.S. 909. Cf. *International Controls Corp.* v. *Vesco*, 490 F. 2d 1334, certiorari denied, June 3, 1974, No. 73-1542.

[4] *Landy* v. *Federal Deposit Insurance Corp.*, 486 F. 2d 139, certiorari denied, 416 U.S. 960.

[5] See, *e.g.*, *Sargent* v. *Genesco, Inc.*, 492 F. 2d 750. Cf. *Hooper* v. *Mountain States Security Corp.*, 282 F. 2d 195, certiorari denied, 365 U.S. 814.

[6] *Simmons* v. *Wolfson*, 428 F. 2d 455, certiorari denied, 400 U.S. 999. Cf. *James* v. *Gerber Products Co.*, 483 F. 2d 944.

[7] See, *e.g.*, *City National Bank* v. *Vanderboom*, 422 F. 2d 221, certiorari denied, 399 U.S. 905.

[8] See, *e.g.*, *Mount Clemens Industries, Inc.* v. *Bell*, 464 F. 2d 339.

[9] *H. K. Porter Co., Inc.* v. *Nicholson File Co.*, 482 F. 2d 421, intimates that the circuit might follow *Birnbaum* were the issue squarely presented.

[10] The decision of the Court of Appeals for the Tenth Circuit in *Jensen* v. *Voyles*, 393 F. 2d 131, is sometimes cited as an adoption of the *Birnbaum* rule. See, *e.g.*, *Landy* v. *Federal De-*

This Court should resolve the conflict and reject the *Birnbaum* rule. The fact that some courts have referred to "difficulties of proof that would accompany abandonment of the rule," Pet. App. A–16, should not preclude an investor or potential investor from attempting to demonstrate, according to the ordinary assessment of damages, loss resulting from a violation of Rule 10b–5. We submit that the mechanical application of the *Birnbaum* rule excludes worthy claims as well as the unworthy, thereby denying a day in court to many of the class of potential investors the Act and Rule were intended to protect.

CONCLUSION

For the foregoing reasons the petition for a writ of certiorari should be granted.

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posit Insurance Corp., *supra*, 486 F. 2d at 156. However, the court in *Jensen* merely held that defendants' false representations must have a relationship to plaintiff's purchase of stock in order for plaintiff to have a cause of action under Rule 10b–5.

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